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AN EMPIRICAL STUDY REGARDING BANKS' TRANSPARENCY DEGREE OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

Abstract. *Financial scandals and the trigger of financial crises also named "morality crises" brought into focus the Internal Control over Financial Reporting. Many worldwide legislative initiatives appeared with the aim of reducing the impact of accounting "errors" derived from frauds, involuntary distortions, omissions or lack of transparency. These aspects justify this study which proposes testing the hypothesis: provided that some European legislative regulations appeared in the current economic context related to the Internal Control over Financial Reporting, then these ones had impact on increasing the degree of transparency regarding the Internal Control over Financial Reporting. One lays emphasis on information disclosure behaviour concerning the Internal Control over Financial Reporting from banks' Annual Report. Researches highlight that, after normalizing the internal control, the analysed banks evidence an increase of transparency degree with 62% through the information disclosure behaviour regarding the Internal Control over Financial Reporting, because the quantity/ quality of the disclosed information increases with 35.417%.*

Key words: *Internal Control over Financial Reporting, transparency, disclosure behaviour, banks, Annual Report.*

JEL Classification: M41, M42, M14.

1. Introduction

The carried out research set itself to monitor the impact of the legislation associated with the requirements for disclosing information related to the Internal Control over Financial Reporting on **the behaviour of some European banks**, relevant from the perspective of the systemic risk. In fact, there was considered **the treatment of the Internal Control over Financial Reporting through information disclosures** within financial statements, as a result of the requirements imposed by regulations. The area of these regulations and the year they came into operation are: the Sarbanes Oxley Act (2002), the European Directives 4, 7 and 8 (2008) or the national regulations from jurisdictions where requirements imposed by the national regulations are more rigorous than the ones from the European directives or became

operative earlier, as it results from the analysis of information presented in the Annual Reports published by the investigated banks.

2. Research Methodology

The study pertains to the sample of the 29 **"too big to fail" banks** named at the end of 2011 by the G20 leaders as the most important banks from the point of view of the systemic risk that comes to them and which "should not be let to fail"[1]. This aspect represented the first selection criterion. The second criterion for selection was **the political and geographical placement** of the study on Europe, respectively the banks with the headquarters in the member states of the European Union, which must also comply with the national law regulations (beside the directives of the European Commission and of the European Union bodies – the community law-) when they are different from the community ones. The third criterion was represented by the **higher level of total assets** held by a bank (whither existed many banks systemic relevant at a worldwide level, with the headquarters in a certain EU member state), on which there was considered the significant bank that entered the subject of the research. This third criterion is justified due to the fact that all banks belonging to one country submit themselves to the same bodies of national bank regulation (e.g. the National Bank of the respective state, the Ministry of Finance, the Consumer Affairs, etc.) and their information disclosure behaviour was considered to be complying with the legislation in force, starting from the supposition that they do not/ should not stand the risk of non-compliance. The delimitation of the studied sample from the 29 worldwide systemic banks is graphically represented in ***Figure 1.***

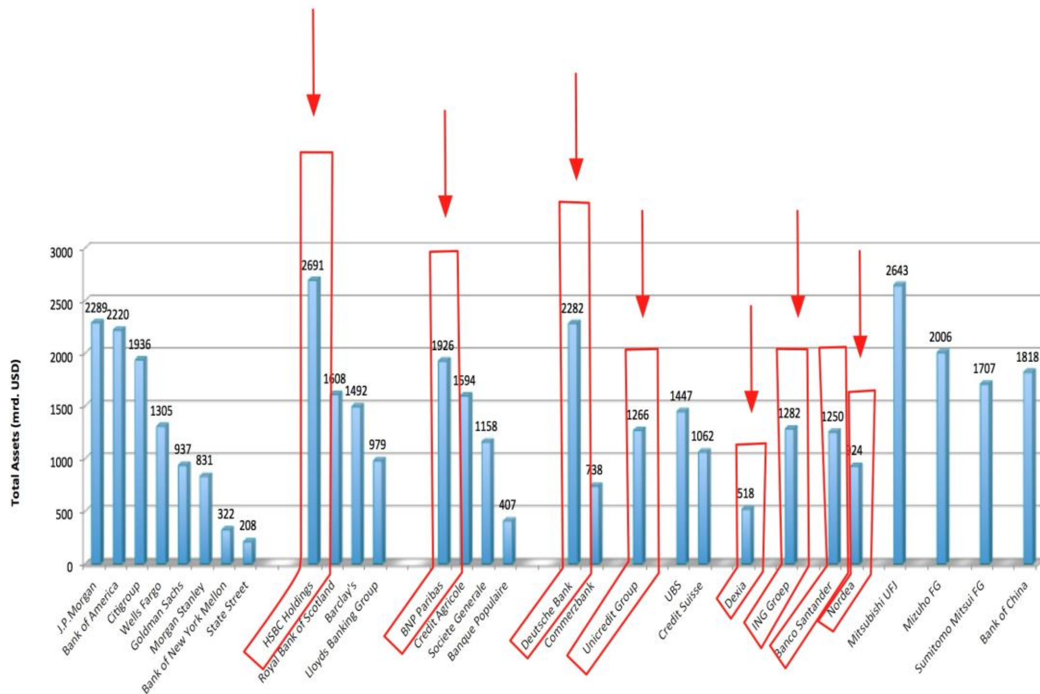

Figure 1 – Establishing the sample on the three criteria of selection, delimitation from the "Too Big to Fail" sample, September 2011 (mrd. USD)

Source: research based on the data available in BANKSCOPE-Database, Bureau van Dijk Electronic Publishing [2]

On the basis of the hereinbefore presented and illustrated aspects, the sample consists of the following banks, decreasingly ordered according to the total assets (***Table 1***):

The Final Sample

Table 1

Bank	**Total Assets (mrd. USD)**	**Country**
HSBC Holdings	2691	Great Britain
Deutsche Bank	2282	Germany
BNP Paribas	1926	France
ING Groep	1282	Holland

Unicredit Group	1266	Italy
Banco Santander	1250	Spain
Nordea	924	Sweden
Dexia	518	Belgium

Source: research based on the data available in BANKSCOPE-Database, Bureau van Dijk Electronic Publishing

While studying the eight banks selected for the sample there existed many **important moments** which would produce impact within the presentations of information, moments that may be grouped into **the following relevant criteria:** *year 2002* (when came into operation the legislation regarding the internal control in USA – SOX), *year 2008* (when came into operation the European directives 43/EC and 46/EC - EuroSOX) and *the years* when *the internal control was normalized on a national level* in the countries where the eight banks have their headquarters. Additionally, if needed, there was also considered *the year when it got listed on the USA stock exchange* (HSBC-1999, Deutsche Bank-2001, ING-2007 and Santander-1987). Details about international stock exchange listing of the banks in the sample are given within ***Table 4: Stock Exchange Listings of the banks in the sample.*** The eight banks in the sample were studied at two different temporal moments: *"before the introduction of legislation"* and *"after the introduction of legislation". Legislation* means *SOX-2002, EuroSOX-2008* or *the national regulations,* if needed. ***Table 2*** presents the regulations related to the Internal Control over Financial Reporting (ICFR) in each country selected for the sample, also specifying the year it came into force.

Regulatory Acts regarding Internal Control over Financial Reporting for the sample elements

Table 2

Country	Regulatory Act	In force
Great Britain	The Disclosure and Transparency Rules 7 [3]	2008
Germany	German Accounting Law Modernisation Act (BilMoG) Bilanzrechtsmodernisierungsgesetzes [4]	2009
France	Financial Security Act [5]	2003

Holland	Corporate Governance in the Netherlands 2002: the state of affairs [6]	2002
Italy	Law No. 262/2005 [7]	2005
Spain	Sustainable Economy Law [8]	2009
Sweden	The Swedish Code of Corporate Governance [9]	2004
Belgium	The Corporate Governance Charter [10]	2008

Source: research on the Regulatory Acts applicable to the studied domain

The comparative-qualitative analysis of the presentations of information regarding the Internal Control over Financial Reporting, information provided in the Annual Reports (abbreviated hereinafter "ICFR Analysis") based on the sample defined after applying the selection criteria, takes into consideration 12 types of information related to the studied object, named **elements to be analysed.** The selection of these elements was performed on the basis of the published information regarding the Internal Control over Financial Reporting pursuant to the requirements presented in national or international legislations, in the international standards which integrate the best internal control practices. In ***Table 3*** there are presented in a structured form the elements chosen for the ICFR Analysis.

Elements of the ICFR Analysis

Table 3

No.	ICFR Elements
1.	Declaring in the Annual Report Management's responsibility for ensuring the existence and activity of ICFR – Element 1
2.	Declaration regarding the methodology applied for measuring the efficacy of the ICFR – Element 2
3.	Expressing Management's / CEO's (Chief Executive Officer) and/or CFO's (Chief Financial Officer) opinion on establishing and maintaining the ICFR and on its efficacy – Element 3
4.	Expressing the External Auditor's opinion on the efficacy of ICFR – Element 4
5.	The existence of a statement regarding a reasonable assurance provided by the ICFR – Element 5
6.	Including the theme related to the ICFR in the agenda of the supervisory structures (The Supervisory Council, The Audit Committee, The Risk Committee) – Element 6

7.	Expressing the supervisory structures' opinion (The Supervisory Council, The Audit Committee, The Risk Committee) on the efficacy of the ICFR – Element 7
8.	Presentation of some details about the way the ICFR is organized – Element 8
9.	Representation of the scope and aim of the ICFR – Element 9
10.	Reference to a model of internal control established on the basis of the international standards representing the best practices of internal control – Element 10
11.	The disclosure of risks afferent to the financial reporting identified along the year in the Annual Report – Element 11
12.	The disclosure of controls afferent to risks identified with regard to the financial reporting in the Annual Report – Element 12

Source: research based on the Annual Reports [11] published by the banks in the sample and the regulation in force

Stock exchanges proved to figure in promoting the corporate governance through the standards imposed by the conditions related to listing, information disclosure and monitoring [12]. According to the literature, this aspect was noticed on the basis of the information analysed and provided by banks through the Annual Report related to banks' listing at New York Stock Exchange. Therefore, the requirements imposed on occasion of listing and the provisions from the SOX legislation had indirectly a positive impact on the behaviour related to the disclosure of financial information by the bank managers from HSBC, Deutsche Bank, ING and Santander. ***Table 4*** offers details about listing the banks selected in the sample at the international stock exchanges.

Stock Exchange Listings of the banks in the sample

Table 4

HSBC	Deutsche Bank	BNP	ING	Unicredit	Santander	Nordea	Dexia
London Stock Exchange	Boerse Frankfurt	Euronext Paris	Euronext Amsterdam	Borsa Italiana - MTA	Bolsa de Madrid	Nasdaq OMX - Stockholm	Euronext Brussels
Bermuda Stock Exchange	Boerse Berlin	Boerse Frankfurt	Euronext Brussels	Boerse Frankfurt	Boerse Frankfurt	Helsinki Stock Exchange	Euronext Paris
Euronext Paris	New York Stock Exchange	London Stock Exchange	US Exchange	Warsaw Stock Exchange	Bolsa de Comercio de Buenos Aires	Nasdaq OMX Copenhagen	Luxembour g Stock Exchange
Hong Kong Stock Exchange	-	Borsa Italiana - MTA	-	-	Bolsa Mexicana de Valores	-	-

New York Stock Exchange	-	-	-	-	Borsa Italiana - MTA	-	-
-	-	-	-	-	Euronext Amsterdam	-	-
-	-	-	-	-	Euronext Lisbon	-	-
-	-	-	-	-	London Stock Exchange	-	-
-	-	-	-	-	New York Stock Exchange	-	-

Source: research based on the data available in BANKSCOPE-Database, Bureau van Dijk Electronic Publishing

In order to determine the impact of legal regulations (of normative acts) from the selected jurisdictions on banks' behaviour related to the disclosure of information regarding the Internal Control over Financial Reporting there were carried on: documentation, investigations, selections, analyses, synthesis, comparisons, qualitative analyses, quantitative analyses. The results of the research performed according to the presented methodology leaded to the identification of information concerning the Internal Control over Financial Reporting provided by the banks from the sample; the status of their disclosure before and after applying the afferent regulation is represented in ***Figure 2.***

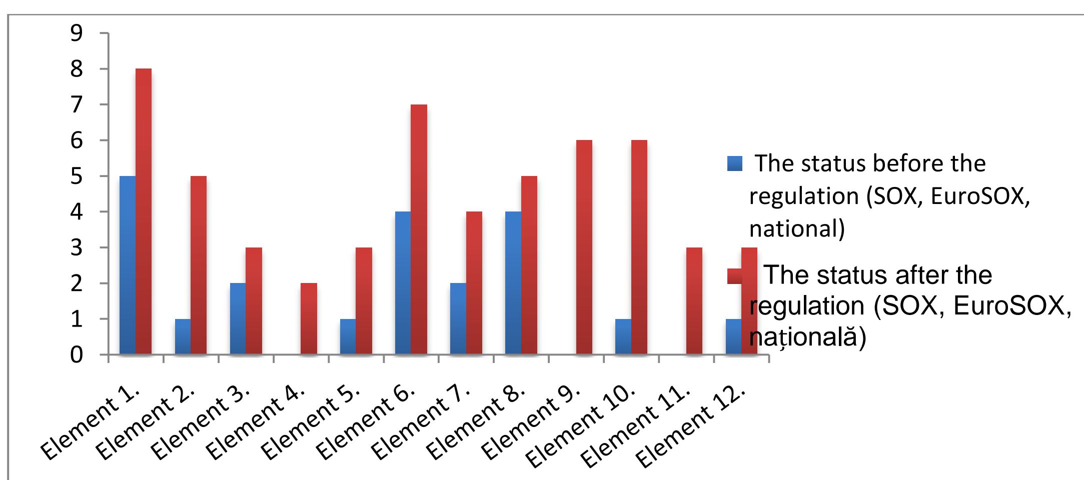

Figure 2 - Results of the ICFR Analysis

Source: research based on the Annual Reports published by the banks in the sample and the regulation in force

According to the research methodology, there were identified 96 elements, respectively 96 possible observations for the 8 banks and 12 elements to be kept track of. So as the studied sample – overall – would have a compliance level of 100%, it means that at the “after introducing regulations” moment of the research it would result the identification of the 96 possible elements.

3. The impact of enacting the ICFR regulations concerning the behaviour of the banks in the sample

From the Annual Reports studied for the two moments in time it asserts that the declared responsibility of the management for ensuring the existence and activity of the ICFR was disclosed both before, and after the criterion considered within the research by most of the banks. At the same time, it is important to mention the fact that after the formalization of the internal control, all banks in the sample included in their reports intended for publication the assertion that managements has the responsibility to ensure the existence and activity of the ICFR, which represents a strictly positive result, respectively an adequate impact of the enactment of regulations concerning the ICFR.

The legislation in force influenced considerably and positively the banks in the sample in regard to the practice to disclose details related to: the methodology applied for establishing the efficacy of the ICFR, the scope and aim of the ICFR, risks and controls identified as being afferent to the financial reporting. At the same time, there resulted a considerable tendency of expansion in regard to the practice to make reference to an internal control model established on the basis of the international standards and of the best practices of internal control. If there was no reference at any model in the studied initial moment, after introducing the legal requirements (in 2011) almost all banks (6 from 8) referred directly or indirectly to an established internal control model. It was made mention of either COSO I or COSO II, and in two cases there were described only the elements of COSO I control (The Control Environment, Risks Management, Controlling, Informing and Communicating Activities, and Monitoring) but without mentioning the name of the established model. The initial moment that was studied is not the same for all banks. Each bank was analysed in order to determine the relevant moment of the analysis, so that there were taken into consideration the following events: year 2002, when the legislation concerning the internal control in the USA (SOX) came into operation, year 2008, when the European directives 43/EC and 46/EC (EuroSOX) became operative and the years when the internal control was nationally normalized in the countries where the 8 banks have their headquarters. ***Table 2*** presents for each country the year when legislation related to the internal control (over financial reporting) came into force.

A relevant result from the analysis of the behaviour related to the disclosure of information on the Internal Control of Financial Reporting lies in the fact that the responsibility, the aim of the supervisory structures (especially of the Audit Committee) and the acceptance of responsibilities being for the monitoring position determined bank managers to mark the problems of the Internal Control over Financial Reporting on the agenda of that meetings. Furthermore, they mentioned this aspect in the Annual Reports. If before the formality of the ICFR, only 4 banks were providing information related to this aspect, in 2011 all the banks in the sample (excepting the Swedish bank Nordea) presented specifications on these lines.

After formalizing the ICFR in normative acts it may be noticed an effect of an average increase related to the disclosure of information concerning the elements analysed per bank at 4.25.

According to the ICFR Analysis, Deutsche Bank proved to have the biggest evolution (9 additional elements) in regard to the disclosure of information after the legislation came into force. In this case the year of the analysis was 2011, comparative to 2001, the year preceding the formalization. Year 2001 was chosen to be studied for Deutsche Bank because of the following criteria: the year SOX came into force – 2002, the year Deutsche Bank was listed at New York Stock Exchange – 2001, the year EuroSOX became operative and the year the "German Accounting Law Modernisation Act" came into force – 2009.

At the same time, according to the results of the analysis, Dexia reduced the level of the disclosed information. If in the year previous to formalization the management of Dexia was including in the Annual Report the opinion of one of the supervisory structure too, in 2011 the disclosed information were limited to the information according to which the ICFR was marked on the agenda of the meetings of supervisory structures. For this reason one may say that the enacted legislation does not lead to a strictly positive result.

A remarkable evolution regarding the addition number of elements included in the Annual Reports which came into the open is recorded by Banco Santander with 8 elements, ING Groep with 7 elements and Unicredit and HSBC, both with 4 additional elements.

Nordea adds in the Annual Report for 2011 3 elements: details about the scope and aim of the ICFR, as well as the disclosure of risks and controls afferent to these ones with regard to the ICFR, excluding at the same time (comparative with the previous year) the details related to marking the ICFR on the agenda of the supervisory structures.

BNP Paribas remains relatively constant when providing information on the Internal Control over Financial Reporting.

Figure 3 offers more details about the behaviour of banks' management when providing information related to the Internal Control over Financial Reporting in the Annual Reports.

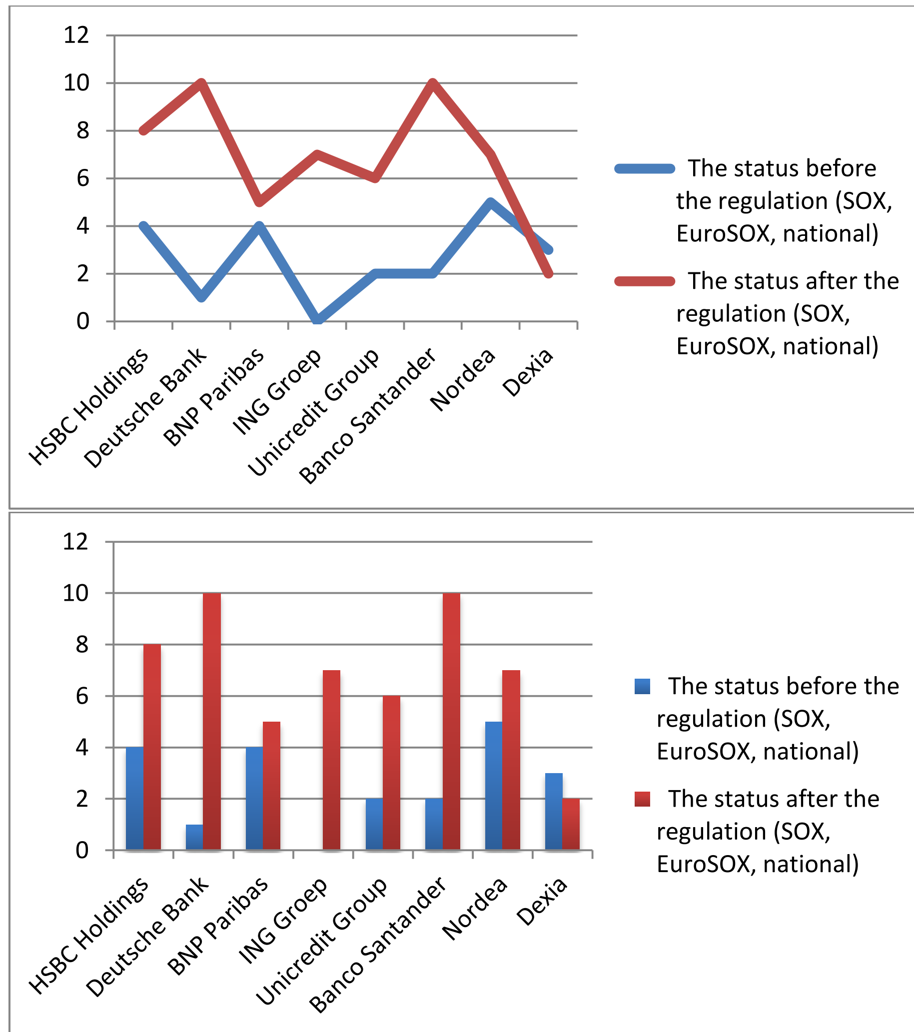

Figure 3 – Bank management behaviour regarding the disclosure of the ICFR Elements

Source: research based on the Annual Reports published by the banks in the sample and the regulation in force

From this study results the aggregated effect produced by the regulatory measures referring to the ICFR. There can be also noticed the **legislative effects** produced by the national legislations, the recommendations of the Code of Corporate Governance, the European Directives 4, 7 and 8, but mostly by the influences of Sarbanes-Oxley Act on the banks in the chosen sample.

According to ISACA [13], due to the intense phenomenon of globalization, the **SOX Act** affects directly the companies in the USA and indirectly "there exist potentially international implications. Actually, there exist numerous factors which must be taken into consideration for compliance with Sarbanes-Oxley Act, some of them having a unique impact on the international organizations" (Stulz, 2009 – translation mine) [14]; it brings evidences that endorse the statement according to which a listing at a stock exchange in USA is for benefits related to the corporative governance: "governing advantages". The advantages consist of the fact that companies adhere to the American regulatory environment, with laws and regulations afferent to the stock and shares, to the supervisory bodies and the US Securities and Exchange Commission (SEC) [15], as well as risk assessment through different models (S.Briciu, A.Socol, L.Rof, 2010) [16] to the monitoring performed by native analysts and institutional investors. The implementation of Article 404 from SOX Act – whose aim is to reduce the market impact of accounting "errors" turned up from frauds, involuntary distortions or omissions, increasing at the same time juridical exposures significant to companies and managers – presents disadvantages too by imposing considerable costs [17]. From the studied sample, four from eight banks (HSBC, Deutsche Bank, ING and Santander) are listed on a USA stock exchange, thus being obligated to apply SOX. Nevertheless, the regulatory function of stock exchanges may be exerted only within an existing legal framework, respectively in the context of the regulation by national authorities and the executive bodies responsible with promulgation of laws. On this line, ***Table 2*** offers details about relevant normative acts from the studied jurisdictions.

4. Conclusions

The results of the research show that previously to taking up the requirements (to specify in the regulations) related to the Internal Control, the 8 banks presents a transparency degree of 21.875%. The transparency degree would have been considered to be of 100% if all banks had presented information regarding all analysed elements. In contrast, after enacting the requirements, the transparency degree went up to 57.292%. Consequently, after the regulation of the internal control, the analysed banks show a more evident degree of transparency through the behaviour regarding the disclosure of information related to their own Internal Control over Financial Reporting; therefore, the quality/ quantity of disclosed information, measured here through the number of identified observations, increases with 35.417%. Moreover, comparing the quantity/ quality of the

information disclosed at the two moments, it may be concluded that the transparency degree has increased with 62%. At the same time, another conclusion can be drawn: the effect of the legislation resulted in an average evolution of the number of banks that include in their Annual Reports the 12 elements already identified. The effects consist of an average of 2.833 additional elements published pursuant to the law. Therefore, the enactment of legal regulations regarding the Internal Control over Financial Reporting had a positive effect, determining **the increment of banks' transparency degree.**

5. Limits of the study

The sample defined by the G20 Group at the end of 2011 (29 banks at a worldwide level) comprises in case of US, Great Britain, France, Germany, Switzerland and Japan not only one systemic bank, but also a group of banks belonging to the same jurisdiction. In the sample of the ICFR Analysis, in case of Great Britain, France and Germany, there was chosen only one bank, the biggest from the point of view of total assets, considering that all banks belonging to one jurisdiction comply with the same regulatory bodies and present a behaviour of not assuming the risk of non-compliance at the minimal legal requirements.

Considering the effect of globalization – the one that the analysed banks carry on an international level – there exist a sample of banks listed at US Stock Exchange complying with conditions imposed by listing and which, therefore, comply with the American regulations and legislation. To conclude with, if one wanted to study only the effects produced by the EuroSOX European legislation, the constraint would consist in the fact that SOX's effects on the banks in the sample cannot be isolated. The same limitation exists in case of studying the banks individually from the requirements imposed by national law.

6. Directions for future research

The results of this research open other reflection directions which may take shape in new researches by extending the selected sample or by "unbending" the selection criteria. The sample defined for this research included only the banks in Europe, but the study may be done on 29 banks included in the "too big to fail" category. Therefore, there could be analysed the banks worldwide relevant from the systemic risk point of view, including in the sample the following jurisdictions: Switzerland, USA, Japan and China. At the same time, for refining the observations and the increment of details on the results of the qualitative analysis there could be taken into consideration elements additional to the chosen 12. For example, there could be noticed if exists a reporting procedure implemented for possible deficiencies of the system of Internal Control over Financial Reporting, if

banks provide organization charts of internal control and/or organization charts of internal control regarding the financial reporting into their annual reports, if exist public information related to the level of training of people involved within the Internal Control over Financial Reporting process.

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